



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	<b>08/28/03</b>	Bill No:	<b>AB 1416</b>
Tax:	<b>Cigarette and Tobacco Products</b>	Author:	<b>Vargas</b>
Board Position:		Related Bills:	<b>AB 35 (Vargas)</b>

### BILL SUMMARY

This bill would:

- Impose an additional excise tax on cigarettes of seven and one-half cents (\$0.075) per cigarette, or \$1.50 per package of 20, and impose an equivalent compensating floor stock tax, operative October 15, 2003. The revenue from the tax increase would be deposited into the Cigarette and Tobacco Products Excise Tax Fund, which this bill would create, and
- Exclude from the 0.85 percent cigarette distributor discount the additional excise tax on cigarettes proposed by this measure.

### ANALYSIS

#### Cigarette Tax Increase

##### Current Law

Pursuant to Revenue and Taxation Code Section 30101 (Cigarette and Tobacco Products Tax Law), an excise tax of 6 mills (or 12 cents per package of 20) is imposed on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes and based on the March 1 wholesale cost of cigarettes. Currently, the surcharge rate for fiscal year 2003-04 is 46.76 percent.

Of the 87 cent excise tax imposed on a package of 20 cigarettes, 2 cents is deposited into the Breast Cancer Fund, 10 cents into the General Fund, 25 cents into the Cigarette and Tobacco Products Surtax Fund, and 50 cents into the California Children and Families First Trust Fund (CCFF Trust Fund). The tobacco products surtax imposed under Section 30123 is deposited into the Cigarette and Tobacco Products Surtax Fund, while the surtax imposed under Section 30131.2 is deposited into the CCFF Trust Fund.

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### Proposed Law

Among other things, this bill would add Article 4 (commencing with Section 30133) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of \$1.50 per package of 20 cigarettes. The tax would be imposed beginning October 15, 2003. The bill would also impose a compensating floor stock tax on the October 15, 2003 cigarette inventory of a dealer, wholesaler and distributor.

The proceeds from the tax increase would be deposited by the Board into the Cigarette and Tobacco Products Excise Tax Fund, which this bill would create in the State Treasury. For the 2003-04 fiscal year and each fiscal year thereafter, thirteen percent of the moneys deposited in the Cigarette and Tobacco Products Excise Tax Fund would be continuously appropriated to the Department of Health Services (DHS) for expenditure to fund tobacco prevention, control, and cessation programs. These funds would be allocated according to a specified formula.

This bill would also require that, for the 2003-04 fiscal year and each fiscal year thereafter, moneys from the Cigarette and Tobacco Products Excise Tax Fund be deposited in the Cigarette and Tobacco Products Surtax Fund (Proposition 99) and the Breast Cancer Fund to reimburse any losses that occur as a result of the imposition of the additional excise tax imposed on cigarettes pursuant to this measure. The Board would be required to determine the fiscal effect the decrease in consumption has on the funding of Proposition 99 state health-related education or research programs and the Breast Cancer Fund programs, to the extent that a decrease in consumption is the direct result of additional taxes.

The remainder of the moneys in the Cigarette and Tobacco Products Excise Tax Fund would be available for appropriation by the Legislature. However, commencing with the 2006-07 fiscal year and for each fiscal year thereafter, the remainder of the moneys in the fund would be available, upon appropriation by the Legislature, for providing funding for the state's costs of providing a tax credit against the costs of health coverage for small employers. This provision would be implemented only if Senate Bill 2 of the 2003-04 Regular Session is enacted and becomes operative, or to the extent that any other act that provides for a tax credit for small employers against the costs of health coverage is enacted and becomes operative.

As a tax levy, the bill would become effective immediately upon enactment. However, the provisions would become operative on the date that is the later of either October 1, 2003, or the date this act takes effect.

### Background

Proposition 99, passed on the November 1988 ballot, effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on tobacco products. Proceeds from the taxes fund health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

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Proposition 10, passed November 3, 1998, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. The revenues from the additional tax are deposited into the CCFF Trust Fund and are used to: (1) fund early childhood development programs, and (2) offset any revenue losses to certain Proposition 99 Programs as a result of the additional tax imposed by Proposition 10.

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the American Lung Association of California, American Cancer Society and the American Heart Association and is intended to provide committed funding, in part, for tobacco cessation programs and other budget related items.
2. **This measure does not contain a corresponding tax increase on tobacco products.** However, the \$1.50 cigarette tax increase would increase the tobacco products tax rate July 1, 2004 as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the tobacco products tax rate, which is required to be determined annually by the Board, must be equivalent to the combined rate of tax imposed on cigarettes. As such, a tax increase on tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased.

However, an increase to the tobacco products tax rate as a result of this bill would not be effective until the 2004-05 fiscal year because current law provides that the Board determine a tobacco products rate "annually." The Board determined the tobacco products tax rate for the 2003-04 fiscal year on May 28, 2003. A new tobacco products tax rate will not be determined until 2004, which would be effective for the 2004-05 fiscal year.

It should be noted that the proceeds from the resulting tobacco products tax increase would not be deposited into the Cigarette and Tobacco Products Excise Tax Fund. The proceeds would be deposited into the Cigarette and Tobacco Products Surtax Fund (created by Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

3. **This measure would increase state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the retail sale is subject to sales or use tax unless specifically exempted or excluded by law. Because the excise tax on cigarettes is not specifically exempted or excluded, it is included in the total amount of the sale and subject to sales or use tax.

This measure would increase the excise tax on cigarettes, which may be passed on to the ultimate consumer through an increase in the retail-selling price of cigarettes. Any increase in the amount of the retail-selling price of cigarettes as a result of this measure would be included in the amount on which sales or use tax is computed. The impact on state and local sales and use tax revenues is shown in the Revenue Estimate.

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4. **This bill contains floor stock tax provisions.** Proposed Section 30135 contains language to impose a floor stock tax on a dealer's, wholesaler's and distributor's inventory. A floor stock tax is important because it equalizes the excise tax paid by cigarette dealers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase. Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes can be raised and attributed to the rate increase, but the additional funds collected are profit and not an excise tax paid to the state. A floor stock tax mitigates this windfall.

As an example of the impact of not having a floor stock tax, in apparent anticipation of the tax increase of 2 cents per package of 20 cigarettes for funding breast cancer research projects beginning in January 1, 1994, sales of cigarette stamps jumped by \$34.8 million in December 1993, or enough stamps for 99 million packs of cigarettes. There was a corresponding decrease in the number of stamps purchased in January and February 1994. Because distributors had an adequate inventory of 35-cent cigarette stamps on hand to affix to their cigarette packages, they could delay for months having to buy the 37-cent stamps which were sold beginning January 1, 1994. This huge inventory stockpiling translated into \$2 million in lost revenue for the Breast Cancer Fund, money which had been anticipated as part of the original revenue estimate.

While there are additional costs associated with administering the floor stock tax, the revenue substantially compensates for that cost.

5. **Would an increase in the cigarette tax increase evasion?** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. Board staff recently estimated that cigarette tax evasion in California was running at a rate of approximately \$292 million annually. That estimate was only for evasion of cigarette taxes, and did not include associated evasion of other taxes, such as sales and use, tobacco products or income taxes.

A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates. For example, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices excluding taxes: Proposition 10 and the Tobacco Master Settlement Agreement made between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

This bill would impose an additional excise tax on cigarettes of \$1.50 per package of 20, and impose an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax. It is assumed that this increase would cause a correlated increase in tax evasion based on the Board's findings when developing the impacts of Proposition 10 and the tobacco settlement.

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6. **Operative date poses concern.** This bill would impose an additional excise tax on cigarettes on and after October 15, 2003. If the Governor were to sign this measure on October 12, 2003, the last day for the Governor to sign or veto bills, the Board would not have sufficient time to properly notify cigarette distributors, wholesalers and retailers of the additional excise tax on cigarettes. This would be problematic since distributors, wholesalers and retailers would not have the knowledge to take an inventory of the number of cigarettes or affixed and unaffixed cigarette tax stamps for purposes of the floor stock tax. This could result in incorrect floor stock returns/reports, subsequent claims for refund, or adjustments on returns/reports. It is recommended that the bill be amended to contain a delayed operative date, such as ten working days after the bill is enacted or October 15, 2003, whichever occurs later.
7. **Suggested technical amendments.** This measure would impose an additional excise tax upon every distributor of cigarettes at the rate of seven cents for each cigarette that is distributed. For purposes of consistency with existing law, the amount of the proposed additional tax should be referred to in "mills" rather than "cents."
- In addition, references to "fund" on page 6, lines 5, 13 and 17, should be specified as the "Cigarette and Tobacco Products Excise Tax Fund" since "fund" is not a defined term.
8. **This bill should contain a specific appropriation to the Board.** This bill would impose an additional excise tax on cigarettes, operative 10 business days following the effective date of the bill, which is in the middle of the state's fiscal year. In order to properly notify cigarette distributors, wholesalers and retailers of the additional tax, develop computer programs, reporting forms, and hire appropriate staff, an adequate appropriation would be required to cover the Board's administrative start-up costs that would not already be identified in the Board's 2003-04 budget.
9. **Related Legislation.** This bill contains similar cigarette tax increase language as AB 35 (Vargas), which would also increase the cigarette tax by \$1.50 per package of 20 cigarettes.

## ANALYSIS

### Distributor Discount

#### Current Law

Section 30161 of the Cigarette and Tobacco Products Law generally provides that the cigarette tax imposed with respect to the distribution of cigarettes shall be paid by distributors through the use of stamps or meter impressions. Section 30163 requires that an appropriate stamp or meter impression be affixed to, or made on, each package of cigarettes prior to distribution of the cigarettes, except as otherwise provided.

Currently, Section 30166 of the Cigarette and Tobacco Products Tax Law provides that stamps and meter register settings be sold to licensed distributors at their denominated values less 0.85 percent. The discount is intended to help defray the cost (leasing of equipment/labor cost) to the distributor for affixing the stamps.

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### Proposed Law

This provision would amend Section 30166 of the Cigarette and Tobacco Products Tax Law to exclude the additional tax on cigarettes proposed by this measure from the 0.85 percent distributor's discount.

### In General

The distributor discount per roll of stamps (30,000 stamps) since August 1, 1967 is as follows:

Period	Tax Increase Pursuant To:	Stamp Value*	Roll Value**	Licensed Distributors Discount	Discount Amount Per Roll
08/01/67-09/30/67	SB 556	\$0.07	\$2,100	.85 percent	\$17.85
10/01/67-12/31/88	SB 556	\$0.10	\$3,000	.85 percent	\$25.50
01/01/89-12/31/93	Proposition 99	\$0.35	\$10,500	.85 percent	\$89.25
01/01/94-12/31/98	AB 3601	\$0.37	\$11,100	.85 percent	\$94.35
1/1/99-Current	Proposition 10	\$0.87	\$26,100	.85 percent	\$221.85

\*Per package of 20 cigarettes

\*\*One roll is equivalent to 30,000 stamps

### Background

In 1960, Assembly Bill 11 (Ch. 12) added Section 30194 to the Revenue and Taxation Code to provide, in part, a 2 percent discount on purchases of tax indicia. In 1961, Assembly Bill 714 (Chapter 884, Stats. 1961) repealed Section 30194 and added Section 30166, which provided that stamps and meter register setting shall be sold at their denominated values less 2 percent to licensed distributors.

Senate Bill 556 (Ch. 963, Stats. 1967) amended Section 30166 to lower the discount provided to licensed distributors from 2 percent to .85 percent.

During the 1984 Legislative Sessions, Senate Bill 1108, which provided for an annual adjustment in the percentage discount based on an inflation adjustment factor, was passed by the Legislature, but vetoed by the Governor. Governor Deukmejian's veto message states, in part, the following:

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"While I recognize that discount rates connected with affixing stamps and meter register settings have remained unchanged for many years despite inflation, I believe the adjustments proposed by this bill would sustain a practice which may no longer be needed. Further, adjusting the discount rates would result in a substantial benefit to cigarette distributors at the direct expense of local governments and California taxpayers."

In 1985, Senate Bill 1640, a bill substantially similar to SB 1108, was introduced. However, that bill failed to pass from its house of origin by the deadline.

Assembly Bill 1768 (2002) would have provided that the 0.85 percent cigarette distributor discount only applies to the first \$0.10 of the value of the stamp or meter impression. However, that provision was amended out of the bill.

## COMMENT

1. **The Board staff does not foresee any administrative problems with this provision.** This provision would simply limit the discount provided to licensed distributors for purchases of stamps and meter register settings. Accordingly, enactment of this measure would not affect the Board's administration of the Cigarette and Tobacco Products Tax Law.

## COST ESTIMATE

A detailed cost estimate is pending. However, the Board would incur costs related to additional cigarette excise tax for notifying potential taxpayers, developing returns, computer programming, developing and carrying out compliance and audit efforts to ensure proper reporting, administering a floor stock tax, and investigative efforts. With respect to the Governor's Budget May Revision, which proposed an additional excise tax on cigarettes of \$0.23 and \$0.40 per package of 20, operative July 1, 2003 and July 1, 2004, respectively, the costs were estimated to be as follows:

<u>2003-04</u>	<u>2004-05</u>	<u>2005-06 and Ongoing</u>
\$5,002,000	\$3,587,000	\$2,341,000

The Board would also incur additional costs to administer a cigarette tax increase as large as the one proposed by this bill. Such costs would be related to audit efforts to ensure that the floor stock tax is properly reported and collected, compliance efforts for additional billings and delinquencies, and an increased investigative staff presence due to increased tax evasion

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**REVENUE ESTIMATE****Background, Methodology, and Assumptions**

For purposes of this estimate, we assume a price elasticity of demand of -0.50, applied to the estimated average 2002 retail cigarette price of approximately \$4.20 per pack.

Tax-paid cigarette distributions were 1,237 million packs in fiscal year 2001-02, down about 4 percent from 2000-01. According to the 2003-04 Governor's Budget Summary, total cigarette consumption is estimated to decline in the range of 3.5 percent annually in the next few years, which is what we also assume for this measure. For the floor stock tax, we assume a three weeks supply of cigarettes.

Assembly Bill 1416 does not directly increase the tobacco products tax. However, the proposed cigarette tax increase flows through to affect the Proposition 99 tobacco products tax increase starting in fiscal year 2004-05. Similar to cigarettes, we assume a price elasticity of demand of -0.50 for tobacco products. We also assume a trend of annual 3.5 percent decreases in tobacco products, as we did for cigarettes.

**Revenue Summary**

The table below summarizes the revenue impacts of Assembly Bill 1416. The decline in consumption related to the cigarette tax increase has the effect of reducing revenues for the General Fund and existing cigarette and tobacco tax funds. These impacts are shown in the table. The table also shows the effects of the proposal on tobacco products in fiscal year 2004-05 as well as the effects of sales taxes applied to the cigarette excise tax increase. As shown in the table, the net increase in cigarette tax revenues is \$877.5 million in fiscal year 2003-04 (partial year impact, including the floor stock tax) and \$1,183.2 million in fiscal year 2004-05 (complete fiscal year). Revenues also increase from tobacco products (in fiscal year 2004-05) and sales taxes.

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Cigarette Tax Increase - Revenue Impacts Summary		Fiscal Year	
Rate Increase Per Pack =		\$1.50	
		2003-04	2004-05
		Millions of Dollars	
Cigarette Excise Tax Revenues by Fund			
AB 1416 (\$1.50/pack)		\$915.8	\$1,361.0
General Fund		-\$13.7	-\$20.4
Breast Cancer		-\$2.7	-\$4.1
Proposition 99		-\$34.4	-\$51.1
Proposition 10		-\$68.7	-\$102.1
Total Cigarette Excise Tax Revenues		\$796.2	\$1,183.2
Floor Stocks Tax		\$81.4	\$0.0
Gross Increase in Other Tobacco Tax Revenues		\$0.0	\$25.7
Proposition 99		\$0.0	\$25.7
Proposition 10 (Consumption Decline Impacts)		\$0.0	-\$2.1
Net Change in Other Tobacco Tax Revenues		\$0.0	\$23.6
Total Net Excise Tax Increase (Cigarettes + OTP)		\$877.5	\$1,206.9
State Sales & Use Tax ( at 5%)		\$43.9	\$60.3
Total State		\$921.4	\$1,267.2
Local Sales & Use Tax (at 2.25%)		\$19.7	\$27.2
Transit Tax (at 0.67%)		\$5.9	\$8.1
TOTAL		\$947.0	\$1,302.5

### Qualifying Remarks

Consumer responses to such large tax increases are uncertain and were estimated based on our best available information. Assembly Bill 1416 greatly increase incentives for tax evasion. Changes in consumer responses and tax evasion by retailers and consumers are difficult to predict. However, such responses could significantly reduce revenues.

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